Takings Clause Analysis of Utility Ratemaking Decisions: Measuring Hope’s Investor Interest Factor

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NOTES

TAKINGS CLAUSE ANALYSIS OF UTILITY RATEMAKING DECISIONS: MEASURING HOPE’S INVESTOR INTEREST FACTOR

INTRODUCTION

In its landmark 1944 decision, Federal Power Commission v. Hope Natural Gas Co., the Supreme Court established a deferential, end result standard for reviewing the constitutionality of government regulation of public utility rates. The Hope test requires courts to examine the balance struck by the ratemaking authority between the competing interests.

1. 320 U.S. 591 (1944).
3. See Hope, 320 U.S. at 602. According to Hope, “[i]f the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry... is at an end.” Id.; see infra notes 64-78 and accompanying text.
5. The term “public utility” is not amenable to precise definition. See C. Phillips, Jr., The Regulation of Public Utilities 4 (1985). One judge has described the elements of a public utility enterprise as follows:

If a business is (1) affected with a public interest, and (2) bears an intimate connection with the processes of transportation and distribution, and (3) is under an obligation to afford its facilities to the public generally, upon demand, at fair and nondiscriminatory rates, and (4) enjoys, in a large measure an independence and freedom from business competition brought about either (a) by its acquirement of a monopolistic status, or (b) by the grant of a franchise or certificate from the State placing it in this position, it is... a public utility. Davies Warehouse Co. v. Brown, 137 F.2d 201, 217 (D.C. Cir. 1943) (Vinson, C.J., dissenting) (emphasis in original), rev’d, 321 U.S. 144 (1944). This definition is subject to exceptions. See, e.g., C. Phillips, Jr., supra, at 105 (a public utility need not be monopolistic). Essentially, public utility enterprises in the United States share two traits: private ownership and public regulation. See id. at 5. Commenting on the public interest with which utilities are affected, Justice Frankfurter observed that “the needs that are met by public utilities are as truly public services as the traditional governmental functions of police and justice.” Federal Power Comm’n v. Hope Natural Gas Co., 320 U.S. 591, 625 (1944) (Frankfurter, J., dissenting). Indeed, it is “[t]his partly public, partly private status of utility property [that] creates its own set of questions under the Takings Clause of the Fifth Amendment.” Duquesne Light Co. v. Barasch, 109 S. Ct. 609, 615 (1989); see also Drobak, supra note 4, at 85 (the Hope Court “retained a specialized doctrine for [the constitutional review of] ratemaking”).
ests of utility investors and consumers.\(^6\)

In applying Hope to specific ratemaking decisions, courts have disagreed on whether the investor interest should be judged relative to prudently incurred investment\(^7\) in the enterprise or relative to property that currently provides electric power to consumers.\(^8\) Ratemaking disputes involving nuclear power plants indicate how crucial this distinction can be.\(^9\) Electric utilities have invested billions of dollars to develop nuclear generating stations,\(^10\) many of which have been abandoned or have yet to provide electricity.\(^11\) The cost of the plants that have come on line has

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6. See Hope, 320 U.S. at 603; infra notes 74-78 and accompanying text.

7. Prudent investment ratemaking provides a return upon the amount prudently invested in the utility by its stockholders—"that is, the original cost minus any fraudulent, unwise, or extravagant expenditures that should not be a burden on the public." C. Phillips, Jr., supra note 5, at 292; see Missouri ex rel. S.W. Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 289 & n.1 (1923) (Brandeis, J., concurring). "Prudent investment" is a term of art taken from the prudent investment method of ratemaking. This method was first advocated by Justice Brandeis in a famous concurring opinion, joined by Justice Holmes. See id. at 289. The "fair return upon fair value," or used and useful ratemaking methodology, was the constitutionally mandated standard at the time of the Southwestern Bell decision. See infra notes 47-51 and accompanying text. Brandeis's prudent investment methodology constituted a departure from the fair return upon fair value standard in two respects. First, it provided for a return upon capital prudently invested by the utility, not upon utility property that was used and useful in providing service. Second, the prudent investment standard provided for a return based on historical cost, as opposed to the Smyth "present fair value" standard. See infra notes 47-55 and accompanying text. The rationale behind the prudent investment standard is that "[t]he thing devoted by the investor to the public use is not specific property . . . but capital embarked in the enterprise." Southwestern Bell, 262 U.S. at 290 (Brandeis, J., concurring).

8. The proposition that a utility enterprise should only earn "a fair return upon the value of that which it employs for the public convenience," Smyth v. Ames, 169 U.S. 466, 547 (1898), stems from an analogy to eminent domain. See Drobak, supra note 4, at 78. The utility has a legal obligation to provide service. See C. Phillips, Jr., supra note 5, at 106; Sommers, Recovery of Electric Utility Losses From Abandoned Construction Projects, 8 Wm. Mitchell L. Rev. 363, 374 (1982); see, e.g., N.H. Stat. Ann. § 374:1 (1984); Pa. Cons. Stat. Ann., Tit. 66, § 1501 (Furden 1979). Courts perceived this service obligation to be a public use of the utility's property requiring just compensation. See Smyth v. Ames, 169 U.S. 466, 546 (1898); Reagan v. Farmers' Loan & Trust Co., 154 U.S. 362, 410 (1894); Drobak, supra note 4, at 79. The public, however, should not be required to pay for something that does not provide service. See Jersey Cent. Power & Light Co. v. F.E.R.C., 810 F.2d 1168, 1175 (D.C. Cir. 1987) (en banc); Tennessee Gas Pipeline v. F.E.R.C., 606 F.2d 1094, 1109 (D.C. Cir. 1979), cert. denied, 445 U.S. 920 (1980); Washington Gas Light Co. v. Baker, 188 F.2d 11, 18 (D.C. Cir. 1950), cert. denied, 340 U.S. 952 (1951); Hoecker, supra note 2, at 333. Therefore, the utility is only entitled to earn a return on property that is currently providing service to its customers. This principle is embodied in the used and useful ratemaking methodology. See Hoecker, supra note 2, at 306-07.


10. See Drobak, supra note 4, at 112 n.223; Pierce, supra note 9, at 497-98.

11. See Pierce, supra note 9, at 497; Note, Consumers' Counsel v. Public Utilities...
far exceeded original estimates. Given the magnitude of these investments, whether a court considers them for the purpose of an inquiry into the reasonableness of utility rates is crucial.

Duquesne Light Co. v. Barasch: a recent instance of rare Supreme Court ratemaking review, sustained the Hope standard's validity but raised questions concerning its implementation. Justice Scalia, in a con-


12. See Glicksman, Allocating the Cost of Constructing Excess Capacity: "Who Will Have To Pay For It All?", 33 U. Kan. L. Rev. 429, 429 (1985); Pierce, supra note 9, at 505.


Some courts have construed the Supreme Court's refusal to hear appeals from allegedly confiscatory ratemaking decisions as an implicit recognition that "[t]he Constitution no longer provides any special protection for the utility investor." Dayton Power & Light, 4 Ohio St. 3d at 99-100, 447 N.E.2d at 740 (quoting Bernstein, Utility Rate Regulation: The Little Locomotive that Couldn't, 1970 Wash. U.L.Q. 223, 259-260). The Court's recent decision in Duquesne Light Co. v. Barasch, however, contradicts this assertion.
curring opinion, questioned what benchmark a reviewing court should employ in analyzing the investor interest factor of the Hope balancing standard. He remarked that "[w]e cannot determine whether the payments a utility has been allowed to collect constitute a fair return on investment, and thus whether the government's action is confiscatory, unless we agree upon what the relevant 'investment' is. For that purpose, all prudently incurred investment may well have to be counted." One court articulated the issue as "whether the end result test is to be applied to a utility overall or only to those assets which valid Commission rules permit to be included in the rate base." This Note examines whether all prudently incurred investment must be considered in a judicial inquiry into the reasonableness of utility ratemaking decisions. Part I examines the Supreme Court's treatment of utility rate regulation prior to Hope. Part II analyzes the Hope decision.


At least one other court has discerned support for its holding in the Supreme Court's dismissing appeals of allegedly confiscatory ratemaking decisions. See Pennsylvania Elec. Co. v. Pennsylvania Pub. Util. Comm'n, 509 Pa. 324, 334-35, 502 A.2d 130, 136 (1985), appeal dismissed sub nom., Metropolitan Edison Co. v. Pennsylvania Pub. Util. Comm'n, 476 U.S. 1137 (1986). In Pennsylvania Electric, the utility commission had excluded the damaged Three Mile Island plant from the rate bases of Metropolitan Edison and Pennsylvania Electric. The utilities claimed that these new rates were confiscatory. See id. at 327, 502 A.2d at 131-132. In rejecting the utilities' contentions, the Pennsylvania Supreme Court observed that "[t]he Supreme Court of the United States has... through dismissal of the Jersey Central appeal, stated implicitly its approval of the holding in that case, and our holding in the instant case is identical to that which was approved in Jersey Central." Id. at 335, 502 A.2d at 136 (citing In re Jersey Central Power & Light Co., No. A-162-81T2 (N.J. Super. Ct., July 28, 1983), cert. denied, 95 N.J. 217, 470 A.2d 433 (1983), appeal dismissed sub nom., Jersey Cent. Power & Light Co. v. Board of Pub. Utilis., 466 U.S. 947 (1984)). In Jersey Central, the Supreme Court dismissed an appeal from an adverse ratemaking decision in a case arising out of the same nuclear plant shutdown at issue in Pennsylvania Electric. However, the court's contention in Pennsylvania Electric that the dismissal of Jersey Central supported its holding is misplaced. While it is true that "a dismissal for want of a substantial federal question is... a decision on the merits," Pennsylvania Electric, 509 Pa. at 335, 502 A.2d at 136, its "precedential effect... extends no further than 'the precise issues presented and necessarily decided by those actions.'" Anderson v. Celebrezze, 460 U.S. 780, 784 n.5 (1983); see R. Stern, E. Gressman & S. Shapiro, Supreme Court Practice 250-51 (6th ed. 1986). Takings analyses are "essentially ad hoc, factual inquiries." Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979); see also Covington & Lexington Turnpike Rd. Co. v. Sandford, 164 U.S. 578, 597 (1896) (analysis of ratemaking decisions depends upon special facts of case). Therefore, the precedential effect of the Jersey Central case is necessarily quite narrow and the Pennsylvania Supreme Court's reliance on that case for support is erroneous. See generally R. Stern, E. Gressman & S. Shapiro, supra, at 247-52 (discussing precedential effect of Court's summary affirmances).

16. See Duquesne, 109 S. Ct. at 620-21 (Scalia, J., concurring).
17. Id.
19. This Note will primarily address issues affecting the electric utility industry.
sion and the end result standard it enunciated. Part III discusses state and federal court application of the Hope standard. This Note concludes that a reviewing court must consider all prudently incurred investment when weighing the investor interest under Hope.

I. BACKGROUND: FROM MUNN TO HOPE

In Munn v. Illinois, the Supreme Court determined that government regulation of prices was constitutional. While Munn settled one constitutional controversy, it sparked another over the limits of government regulation.

The first significant ratemaking decision after Munn came in the Railroad Commission Cases, where the Court upheld the constitutionality of a Mississippi statute that created a commission to regulate railroads operating in the state. The Court reaffirmed Munn and began to define the limits on government ratemaking. In an oft-quoted comment, the Court declared that:

[i]his power to regulate is not a power to destroy, and limitation is not the equivalent of confiscation. Under pretense of regulating fares and freights, the State cannot . . . do that which in law amounts to a taking of private property for public use without just compensation, or with-


21. 94 U.S. 113 (1876).

22. See id. at 130 ("when private property is devoted to a public use, it is subject to public regulation"). For a discussion of the origins of government price regulation, see id. at 124-30; C. Phillips, Jr., supra note 5, at 75-79.

23. Munn failed to make clear that the judiciary could review government regulation of prices. The Munn court declared that "it has been customary from time immemorial for the legislature to declare what shall be reasonable compensation . . . . For protection against abuses by legislatures the people must resort to the polls, not to the courts." Munn, 94 U.S. at 133-34. Over the next twenty years, however, the Court established the propriety of judicial review of ratemaking decisions. See Drobak, supra note 4, at 71-75; infra notes 31-36 and accompanying text.


25. See id. at 336.

26. See id. at 335.

27. See id. at 331.

The limitations on government regulation expressed in the Railroad Commission Cases became firmly established as the Court reaffirmed the decision over the next several years. The Court also began to endorse judicial review of ratemaking decisions.

That endorsement came in Reagan v. Farmers' Loan & Trust Co. Justice Brewer's opinion for the Reagan Court drew an analogy between rate regulation and the law of eminent domain. Brewer concluded that utility property subject to state regulation (taken for public use) must be compensated according to its actual value. The Reagan Court also reiterated the limits on government ratemaking first articulated in the Railroad Commission Cases. Reagan held that a rate reduction which set rates insufficient to pay interest on debt or dividends on stock was unjust and unreasonable.

The first case to hold expressly that rates must be high enough to generate dividends in the absence of proof that the public interest justified lower rates was Covington & Lexington Turnpike Co. v. Sandford. The Sandford Court discussed the public and private interests in utility rate determinations and refined the limits on government rate regulation. Sandford declared that a turnpike company was entitled to tolls that enabled it to keep its road in proper repair and pay dividends on its stock. The public, however, had an interest in paying only reasonable tolls.

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29. 116 U.S. at 331.
31. See Chicago Railway, 134 U.S. at 455; Drobak, supra note 4, at 71-75; supra note 23.
32. See 154 U.S. 362, 399 (1894) ("[I]t is within the scope of judicial power and a part of judicial duty to restrain anything which, in the form of a regulation of rates, operates to deny to the owners of property invested in the business of transportation that equal protection which is the constitutional right of all owners of other property."); Drobak, supra note 4, at 73.
35. See Reagan, 154 U.S. at 399.
36. See id. at 412-13.
37. 164 U.S. 578 (1896); see Drobak, supra note 4, at 76.
38. See Sandford, 164 U.S. at 596-97. The Sandford Court also adopted Justice Brewer's eminent domain analogy from Reagan. See id. at 593-94 (discussing Reagan v. Farmers' Loan and Trust Co., 154 U.S. 362 (1894)).
39. See Sandford, 164 U.S. at 596.
40. See id. at 596-97.
In the first landmark utility ratemaking case, Smyth v. Ames, the Court found that rates fixed under a Nebraska statute were unreasonably low and therefore violative of the fourteenth amendment. The Smyth Court noted the special situation of a public utility: "A railroad is a public highway, and none the less so because constructed and maintained through the agency of a corporation deriving its existence and powers from the State." In weighing the public and private interests, the Court stated that investors must receive compensation for the use of their property, though observing that "[h]ow such compensation may be ascertained, and what are the necessary elements in such an inquiry, will always be an embarrassing question."

The Smyth Court concluded that "[w]hat the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience." Thus, the utility is permitted to earn a return only on that property currently providing service to customers. Smyth's fair-return-upon-fair-value standard is generally viewed as an adoption of the used and useful ratemaking methodology. After Smyth, it was the only constitutionally permissible ratemaking methodology.

The fair-return-on-fair-value test may have been appealing in theory, but it was problematic in practice. The test required a court to determine the "fair value" of a utility enterprise, a task that became increasingly complex and imprecise. In Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service

41. See Hanson & Davies, Judicial Review of Rate of Return Calculations, 8 Wm. Mitchell L. Rev. 499, 531 (1982); Hoecker, infra note 2, at 305; cf. Drobak, supra note 4, at 76 (Smyth dominated utility law for nearly fifty years).
42. 169 U.S. 466 (1898).
43. See id. at 528, 550.
44. Id. at 544; see supra note 5 and accompanying text; infra note 127 and accompanying text.
46. Id. at 546.
47. Id. at 547 (emphasis added).
48. See Drobak, supra note 4, at 77-78; Hoecker, supra note 2, at 305 & n.12. For a discussion of the used and useful standard of ratemaking, see supra note 8.
49. See Jersey Cent. Power & Light Co. v. F.E.R.C., 810 F.2d 1168, 1175 (D.C. Cir. 1987) (en banc); Hoecker, supra note 2, at 305-06.
50. If one accepts Justice Brewer's application of the eminent domain analogy, see supra note 33 and accompanying text, then indeed fair value should be accorded to investors. However, the eminent domain analogy proved inappropriate. See Washington Gas Light Co. v. Baker, 188 F.2d 11, 18-19 (D.C. Cir. 1950), cert. denied, 340 U.S. 952 (1951); Drobak, supra note 4, at 83; Harbeson, The Demise of Fair Value, 42 Mich. L. Rev. 1049, 1054 (1944). While rates must be reasonable, regulation does not per se effect a taking of property requiring just compensation. See Permian Basin Area Rate Cases, 390 U.S. 747, 769 (1968) (government may "limit stringently" investor returns); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 601 (1944); Washington Gas Light, 188 F.2d at 18-19.
51. See Duquesne Light Co. v. Barasch, 109 S. Ct. 609, 616 & n.5 (1989); Missouri ex rel. S.W. Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 296-301, 301 n.13 (1923) (Brandeis, J., concurring); Hale, The Fair Value Merry-Go-Round, 33 Ill. L. Rev. 517, 517 (1939); Henderson, Railway Valuation and the Courts, 33 Harv. L. Rev. 1031, 1051
Commission, Justice Brandeis noted that the Smyth rule was "legally and economically unsound." He proposed replacing it with a standard that focused not on the utility's property but on the "amount prudently invested in [the utility]" by its stockholders. Brandeis reasoned that the "thing devoted by the investor to the public use is not specific property . . . but capital embarked in the enterprise." If the prudent investment methodology had been adopted by the Court, as Brandeis advocated, it would have replaced fair-return-on-fair-value as the constitutionally mandated ratemaking methodology. It failed to become the constitutional standard, as the Hope Court eschewed the elevation of any ratemaking methodology to constitutional status. The prudent investment standard would, in part, prevail in the long run, however, as Hope and its progeny analyzed investor interests in terms of prudently incurred investment.

The Southwestern Bell decision, coupled with widespread criticism by commentators and utility commissions, led to an erosion of the Smyth standard and foreordained its eventual demise. Indeed, many influential jurists either criticized or limited the Smyth standard. Despite the criticism, it remained the constitutionally-mandated standard of review until the decision in Federal Power Commission v. Natural Gas Pipeline. In that case, the Court retreated from the Smyth fair value standard, declaring that "[t]he Constitution does not bind rate-making bodies to the service of any single formula." Natural Gas Pipeline "start[ed] a

(1920); Hoecker, supra note 2, at 307; Kauper, Wanted: A New Definition of the Rate Base, 37 Mich. L. Rev. 1209, 1212 (1939).
52. 262 U.S. 276 (1923) (Brandeis, J., concurring).
53. Id. at 290.
54. Id. at 289 (footnote omitted); See supra note 7.
55. Southwestern Bell, 262 U.S. at 290.
56. See infra notes 64-78 and accompanying text.
57. See infra notes 98-121 and accompanying text.
58. See Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 301-02 & nn. 13-14 (1923) (Brandeis, J., concurring); C. Phillips, Jr., supra note 5, at 162, 294-95; Hoecker, supra note 2, at 308 n.25; Kauper, supra note 51, at 1209 ("The current frontal attack on the 'fair value' theory constitutes one of the most vigorous and uncompromising assaults ever made upon any single specific rule enunciated and developed by the Court in its interpretation of the due process clause." (footnote omitted)).
60. 315 U.S. 575 (1942).
61. Id. at 586. Natural Gas Pipeline construed the requirement of the Natural Gas Act of 1938, 15 U.S.C. § 717d (1988), that rates be "just and reasonable." See Hope, 320 U.S. at 602. The Court remarked that "[b]y longstanding usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense. . . . It follows that the Congressional standard prescribed by this statute coincides with that of the Constitution . . . ." Natural Gas Pipeline, 315 U.S. at 585-86; see Permian
new chapter in the regulation of utility rates." No longer would the Court engage in the detailed, microeconomic analysis of the utility enterprise that the Smyth standard entailed. Rather, "[i]f the Commission's order, as applied to the facts before it and viewed in its entirety, produces no arbitrary result, [the] inquiry is at an end." Thus, the Court was moving away from a standard which focused on ratemaking methodology to one which would instead focus on the results of ratemaking decisions.

II. Takings Clause Analysis of Utility Rates


*Federal Power Commission v. Hope Natural Gas Co.* was decided in 1944, two years after the *Natural Gas Pipeline* decision. In *Hope*, the Court underscored its abandonment of the Smyth standard and enunciated a new constitutional standard for evaluating utility rates. *Hope* reversed a decision by the Court of Appeals for the Fourth Circuit that had invalidated a Federal Power Commission ("FPC") order fixing rates under the Natural Gas Act. The Fourth Circuit had set aside the FPC's order on the traditional grounds that the rate base should reflect

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62. *Natural Gas Pipeline*, 315 U.S. at 601-02 (Black, Douglas, and Murphy, JJ., concurring).
63. *Id.* at 586.
64. 320 U.S. 591 (1944).
65. *See id.* at 601-03.
68. Utility rates are typically calculated according to the revenue requirement standard, see C. Phillips, Jr., *supra* note 5, at 157, which is represented by the following formula:

\[
R = O + (V - D)r
\]

"R" is the total revenue required; "O" is operating costs (e.g., wages, fuel, maintenance, depreciation, amortization); "(V - D)" is the rate base, with "V" being gross cost of tangible and intangible property and "D" being the accrued depreciation on such property; and "r" is the allowed rate of return on rate base. *See id.* at 157-58; Drobak, *supra* note 4, at 94 n.139; Pierce, *supra* note 9, at 511-12; Note, *supra* note 9, at 348-51. A utility's revenue ("R") is calculated by adding its operating costs ("O") and its return on rate base ("(V-D)r"). *See C. Phillips, Jr., supra* note 5, at 157-58. Typically, the rate base represents the utility's assets that are used and useful in providing service to its customers. *See Hoecker, supra note 2, at 303; Note, supra note 9, at 349 n.32. Each state has its own standards for determining what property is used and useful. *See Note, supra* note 9, at 349 & n.12. *Compare* Office of Consumers' Counsel v. Public Utils. Comm'n, 67 Ohio St. 2d 153, 164, 423 N.E.2d 820, 827 (1981) (construing Ohio Rev. Code Ann. § 4909.15 (Anderson 1977) as prohibiting recovery of cost of cancelled nuclear plant because it is not used and useful), *appeal dismissed sub. nom.*, Cleveland Elec. Illuminating Co. v. Office of Consumers' Counsel, 455 U.S. 914 (1982) with People's Org. for Wash. Energy Res. v. Utilities & Transp. Comm'n, 104 Wash. 2d 798, 822, 711 P.2d 319, 333 (1985) (construing Wash. Rev. Code § 80.04.250 (1962) as permitting recovery of cancelled plant costs).
“present fair value” and that “actual legitimate cost” (historical cost) was not the proper measure of “fair value.” The Smyth standard had required a return upon fair value, not upon historical cost of utility property.

Noting the circularity of the fair return on fair value standard, the Supreme Court declared that “fair value is the end product of the process of rate-making not the starting point . . . . [R]ates cannot be made to depend upon ‘fair value’ when the value of the going enterprise depends on earnings under whatever rates may be anticipated.” Discussing Natural Gas Pipeline, the Court articulated the constitutional inquiry as follows: “If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end.” The Court thus retreated from an analysis of ratemaking methodologies employed by ratemaking authorities. Instead, the Court shifted the emphasis of the constitutional inquiry to the effects of rates regardless of the methodology under which they had been set.

According to Hope, a court must consider the competing interests of investors and consumers when determining whether the result of a ratemaking decision is unreasonable. The Court asserted that the utility investor “has a legitimate concern with the financial integrity of the company.” The investor’s return “should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.” The “end result” test that emerged from Hope remains the constitutional standard for utility ratemaking.

B. Application of the Hope Standard

Hope mandates end results that are “just and reasonable,” but those

70. See supra note 8.
71. See Hope, 320 U.S. at 601; Hale, supra note 51, at 517.
72. Hope, 320 U.S. at 601 (footnotes omitted).
73. Id. at 602.
74. See id. at 603.
75. Hope articulated the investor interest in a ratemaking decision but did not expound upon the consumer interest. See Federal Power Comm’n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944); Drobak, supra note 4, at 86-87. The Hope Court need not have considered “the public interest in reaching its decision because Hope would still earn enough under the new reduced rates to satisfy the investor part of the constitutional test.” Drobak, supra note 4, at 87. Nonetheless, the consumer interest is an important component in the Hope balancing approach. See Federal Power Comm’n v. Texaco, Inc., 417 U.S. 380, 392-93 (1974); Drobak, supra note 4, at 88-93.
76. Hope, 320 U.S. at 603.
77. Id. at 603 (citing Missouri ex. rel. S.W. Bell Telephone Co. v. Public Service Comm’n, 262 U.S. 276, 291 (1923) (Brandeis, J., concurring)).
79. Hope, 320 U.S. at 603.
terms are difficult to define with precision. Moreover, Hope and its progeny provided few criteria by which a reviewing court can judge the end result of a rate order. The Court itself has applied Hope infrequently. Without guidance, courts have differed over how to weigh the investor interest factor in the balancing of interests that Hope mandated.

A typical example of the resulting confusion, and the stakes commonly involved, arose in a line of cases involving the Federal Energy Regulatory Commission ("FERC") and Jersey Central Power & Light Company ("JCP&L"). JCP&L requested amortization over fifteen years of its $397 million investment in the abandoned Forked River nuclear generating station. The company also requested rate base inclusion for the unamortized balance of its investment with a rate of return sufficient to

80. See C. Phillips, Jr., supra note 5, at 163.
82. See Drobak, supra note 4, at 67-68 & n.10; Hanson & Davies, supra note 41, at 531.
85. See 810 F.2d 1168, 1171. There are three ways to treat sunk costs in cancelled generating plants. See Heath, Melicher & Gurley, supra note 9, at 16; Pierce, supra note 9, at 542; Comment, Cancelled Utility Plant and Traditional Ratemaking Theories: Are Either Used and Useful?, 22 San Diego L. Rev. 669, 682 (1985). First, a utility commission could deny any recovery of sunk costs. See Heath, Melicher & Gurley, supra note 9, at 16; Comment, supra, at 692. Obviously, this is the worst scenario for the utility. See Heath, Melicher & Gurley, supra note 9, at 16; Pierce, supra note 9, at 542. The other two ways to treat sunk costs involve amortization, which is the "gradual extinguishment of a loss or debt." Comment, supra, at 681 n.90. Both amortization treatments expense (amortize) the investment in cancelled plant over a specified period of years. See Heath, Melicher & Gurley, supra note 9, at 16; Comment, supra, at 681 n.90. This yearly amortization charge is included as an operating expense that is reimbursed in the utility's total revenue allowance. See Heath, Melicher & Gurley, supra note 9, at 16.

The difference between the amortization methods is in their treatment of the unamortized balance of the loss. The unamortized balance of the loss may or may not be included in the rate base upon which the utility earns a return. A utility would recover all of its sunk costs through amortization without rate base treatment of the unamortized balance. However, the present value of the recovery would be less than the sunk costs because of the time value of money. See Heath, Melicher & Gurley, supra note 9, at 16; Comment, supra, at 681 n.90. From the utility's perspective, the most advantageous treatment of the costs involves amortization with rate base treatment for the unamortized balance of sunk costs. See Heath, Melicher & Gurley, supra note 9, at 16; Comment, supra, at 682-83. In this case, the utility would earn a return on their unamortized costs until the entire loss had been amortized. See Heath, Melicher & Gurley, supra note 9, at 16.
cover the carrying charges of its debt and preferred stock.\textsuperscript{86} FERC allowed the amortization, but denied rate base treatment of the investment.\textsuperscript{87} In the ensuing litigation, FERC first contended that “it is well-settled that the end result test only has application to items which are legitimately included in the rate base as ‘used and useful.’”\textsuperscript{88} FERC subsequently reversed itself, conceding in its second response that “the end result test does not only apply to those assets which valid Commission rules permit to be included in the rate base. . . . [but] to the overall situation produced by the Commission’s action . . . .”\textsuperscript{89}

Some courts have held that the investor interest should be measured by utility property that is used and useful in providing electricity.\textsuperscript{90} Other courts have held that the investor interest is properly measured by the amount prudently invested in the utility enterprise by its shareholders.\textsuperscript{91}

The distinction between the two measures of the investor interest is crucial, particularly in the context of incomplete or abandoned nuclear generating stations.\textsuperscript{92} In fact, the issue has arisen most frequently in de-
deciding whether to allow recovery of investments in nuclear power plants by electric utilities. Utilities have enormous investments in incomplete or abandoned nuclear generating stations. The distinction between the two treatments of the investor interest can have important ramifications: the prudently-incurred investment of the Public Service Company of New Hampshire, for example, is four times the value of its used and useful property.

III. THE INVESTOR INTEREST IN THE HOPE BALANCE

A. The Language of Hope and its Progeny

Courts that have concluded that "Hope requires . . . just and reasonable rates providing a return on used and useful property" have misconstrued Hope and its progeny. Hope simply required just and and useful methodology. Typically, a utility that is denied current recovery of CWIP is allowed to capitalize its CWIP costs in an account called "allowance for funds used during construction" ("AFUDC"). AFUDC is treated as a current item for accounting purposes. That is, the utility records the capitalization of AFUDC as income. Thus, on paper there is no significant difference between AFUDC and CWIP treatment. AFUDC treatment, however, does not allow a current cash recovery of the utility's cost of capital associated with financing the construction of new plant. See Mid-Tex Coop., 773 F.2d at 331; Order No. 474, 39 F.E.R.C. ¶ 61,334, published in 52 Fed. Reg. 23,948, at 23,964 (1987) (codified in 18 C.F.R. § 35.26 (1988)). When the plant is completed and becomes operational, the utility may include AFUDC in the rate base upon which it earns a cash return. See Mid-Tex Coop., 773 F.2d at 331. A regulatory agency may allow some hybrid of AFUDC and CWIP treatment where some of the CWIP is included in rate base while the rest is placed in AFUDC. See, e.g., Mid-Tex Coop., 773 F.2d at 331 (FERC allows 50% CWIP treatment with the other 50% placed in AFUDC); Order No. 474, 39 F.E.R.C. ¶ 61,334, published in 52 Fed. Reg. 23,948, at 23,964 (1987) (codified in 18 C.F.R. § 35.26 (1988)) (same).

93. Recovery of investments in cancelled plants involves amortization without rate base treatment of the unamortized balance of sunk costs. See Hearth, Melicher & Gurlay, supra note 9, at 16; supra note 85.

94. Recovery on the amount invested entails amortization with inclusion of the unamortized balance of expenses in the rate base. See Hearth, Melicher & Gurlay, supra note 9, at 16; supra note 85.

95. See Fierce, supra note 9, at 499, 505; Hoecker, supra note 2, at 321.

96. See supra notes 10-13 and accompanying text.

97. See supra note 13.

reasonable results; it did not qualify that requirement. Therefore, modifying Hope's end result standard adulterates the constitutional inquiry. Moreover, the Hope Court asserted that "it is the result reached not the method employed which is controlling," thus rejecting the use of any particular ratemaking methodology in the constitutional inquiry. Used and useful is a ratemaking methodology; by making it part of the constitutional inquiry, courts have misconstrued Hope's mandate.

While the Supreme Court has provided little guidance on how to apply the constitutional standard Hope mandates, the Court did offer some guidance in determining whether rates are fair: arriving at "'just and reasonable' rates involves a balancing of the investor and the consumer interests." The Court then delineated the investor interest:

[T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

The Hope Court did not articulate the investor interest in terms of property that is used and useful. Rather, it defined the investor interest described in Hope as "an interest in return on investment." This conclusion is buttressed by the Hope Court's analysis of the return to the Hope Natural Gas Company. First, the Court noted that in less than forty years, the Hope Company had earned almost seven times its initial equity investment. The Court rejected Hope's contention that its new rates would only have yielded it a return on rate base of

100. Id. at 602.
102. See supra note 8 and accompanying text.
104. See supra notes 79-82 and accompanying text.
106. Id. (citations omitted).
108. Jersey Central, 810 F.2d at 1181 (emphasis in original); see Drobak, supra note 4, at 85, 121.
110. See id. at 603-04.
3.27 percent. Instead, the Court accepted the FPC's contention that a more accurate measure of Hope's "actual operations" revealed that "Hope earned an annual average return of about 9% on the average investment." Thus, the Hope Court focused its inquiry on the company's return on investment.

The Court's most recent application of Hope supports this conclusion. In Duquesne Light Co. v. Barasch, the Court analyzed the effects of the rate orders in two steps. First, the Court determined the total revenue allowance afforded the utilities under the rate orders at issue. Next, the Court analyzed the returns on equity that these revenue allowances would imply, assuming the utilities' requested amortization had been allowed as an expense. This two-step process is similar to the one the Court employed in Natural Gas Pipeline:

The establishment of a rate for a regulated industry often involves two steps of a different character, one of which may appropriately precede the other. The first is the adjustment of the general revenue level to the demands of a fair return. The second is the adjustment of a rate schedule conforming to that level so as to eliminate discriminations and unfairness from its details.

The Duquesne Court concluded that these revenue allowances, and the returns on equity they would imply, would not be confiscatory. Thus, the Court analyzed the utilities' returns in terms of capital investment, rather than property that was used and useful.

B. Constitutional Incorporation of "Used and Useful" Deleterious to Consumers?

Courts that articulate the investor interest of Hope in terms of a return on used and useful property needlessly skew the balancing of investor

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111. See id. at 602, 605 (emphasis added).
112. See id. at 605; Jersey Central Power & Light Co. v. F.E.R.C., 810 F.2d 1168, 1181 (D.C. Cir. 1987) (en banc); Drobak, supra note 4, at 121.
114. The Court need not have analyzed the effect of the rate order. The affected utilities had challenged the Pennsylvania statute as facially confiscatory. See id. at 618. Neither of the utilities involved had alleged that the total effect of the rate order would be unjust or unreasonable. See id. Nonetheless, the Court must have deemed an articulation of this analysis important enough to warrant inclusion in its opinion.
115. This is the "R" term of the utility ratemaking formula discussed supra note 68.
116. See Duquesne, 109 S. Ct. at 618.
117. This is the "r" term of the utility ratemaking formula discussed supra note 68.
120. See Duquesne, 109 S. Ct. at 618.
121. See id.; Jersey Cent. Power & Light Co. v. F.E.R.C., 810 F.2d 1168, 1181 (D.C. Cir. 1987) (en banc); Washington Gas Light Co. v. Baker, 188 F.2d 11, 18-19 (D.C. Cir. 1950), cert. denied, 340 U.S. 932 (1951). But see Hoecker, supra note 2, at 311-12 n.38 ("When Hope, following Brandeis' concurrence in Southwestern Bell, began measuring the investors' interest in terms of capital invested rather than property owned, it arguably extended the philosophy of used and useful to all parts of a rate").
and consumer interests. Typically, these courts deny utility investors a return on property that is not used and useful on the grounds that allowing such a return would be unfair to consumers. But the Hope analysis explicitly considers the consumer interest. By considering the consumer interest both in formulating the investor interest and in weighing the investor interest against the consumer interest, a court gives undue weight to the consumer interest. This approach is neither logical nor in accord with Hope and its progeny. Moreover, it is unnecessary to weigh the consumer interest twice: the Hope balancing test provides adequate protection of consumer interests.

This distortion of the Hope balance of interests in favor of the consumer is improvident as well as improper. It ignores the special relationship between the public utility and the consumer. In fact, consumers may ultimately be harmed by a balancing of interests that unnecessarily weighs in their favor. By slanting the balance of interests in favor of

122. See Jersey Central, 810 F.2d at 1190 (Starr, J., concurring) (used and useful is safeguard imposed to benefit ratepayers); Washington Gas Light, 188 F.2d at 18 & n.29.


124. For example, suppose that Utility A has total invested capital of $100, 20 percent of which has been prudently incurred but is not used and useful. A court that articulates the investor interest in terms of return on property that is used and useful will weigh Utility A's investment of $80 in property that is used and useful against the consumers' interest in non-exploitive rates. In essence, the consumers' interest will have been considered twice: first, in the exclusion of investment in property that is not used and useful, and again in the Hope balancing of interests. More properly, the investor interest should be considered relative to the total prudently incurred investment, here $100, as well as the other investor interests discussed in Hope. Incorporating the used and useful approach in the constitutional inquiry could skew the balance of interests in closer cases. In any event, it is not an approach advanced by the Supreme Court. See supra notes 99-112 and accompanying text.

125. See supra notes 99-112 and accompanying text.

126. See Hoecker, supra note 2, at 334. The Court has made clear that "[r]egulation may, consistently with the Constitution, limit stringently the [investor's] return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." Permian Basin Area Rate Cases, 390 U.S. 747, 769 (1968) (citation omitted) (emphasis added); cf. Drobak, supra note 4, at 97 ("substantial public interest can justify a good deal of economic harm to the investor interest without violating the Constitution"). For a discussion of the consumer interest factor of the Hope test, see Drobak, supra note 4, at 86-98.


128. See Southwestern Bell, 262 U.S. at 308 (Brandeis, J., concurring); Union Elec. Co.
consumers, courts unnecessarily increase investor risk. By decreasing the likelihood that a utility will prevail in a constitutional challenge to an adverse ratemaking decision, courts increase the risk that an unreasonable rate may be allowed to stand. Concomitant with this increased risk level, investors will demand higher returns on their investments. In the long run, "[t]he cost of new capital [will] increase and service [will] deteriorate unavoidably because of the scarcity of reasonably priced capital." Unnecessarily weighing the balance of interests in favor of consumers also provides incentives to utility managers that are deleterious to consumers. By not considering prudently-incurred expenditures for prop-

v. F.E.R.C., 668 F.2d 389, 397-98 (8th Cir. 1981); Citizens Action Coalition, 485 N.E.2d at 623-24 (Prentice, J., dissenting); Dubin & Navarro, Regulatory Climate and the Cost of Capital, in Regulatory Reform and Public Utilities 141, 141-42, 160-61 (M. Crew ed. 1982); Comment, supra note 85, at 696-97. One commission has observed that the question is not who should bear the costs of failed efforts to develop nuclear power plants, but when these costs should be faced. See Attorney General v. Department of Pub. Utils., 390 Mass. 208, 219, 455 N.E.2d 414, 420 (1983).


property that is not used and useful,\textsuperscript{132} courts provide disincentives\textsuperscript{133} to the development of capital-intensive\textsuperscript{134} generating plants—plants that may hold the promise of providing cheaper service\textsuperscript{135} and reducing the country's dependence upon imported oil.\textsuperscript{136}

The development of new generating capacity entails planning and in-

Industry officials are already concerned that construction of new capacity has not kept pace with demand, in part because of "uncertainty among utilities about the financial risk in building new plants." Wald, Growing Use of Electricity Raises Questions on Supply, N.Y. Times, Mar. 21, 1990, at D1, col. 1; see also Wald, Con Ed Wants to Stifle Demand, N.Y. Times, Mar. 26, 1990, at D1, col. 3 (Con Edison's past problems constructing new capacity have left it wary to build).

132. For discussions of the used and useful methodology at the ratemaking level, see Hoecker, supra note 2, passim; Comment, supra note 85. Regardless of whether the used and useful policy is utilized by the ratemaking authority, the constitutional inquiry should nonetheless consider all prudently incurred investment in the Hope balancing of interests. Utilities in states that employ the used and useful methodology and in states that do not should be accorded the same constitutional review.

133. See State ex. rel. Union Elec. Co. v. Public Serv. Comm'n, 687 S.W.2d 162, 166 (Mo. 1985) (en banc); Wisconsin Pub. Serv. Corp. v. Public Serv. Comm'n, 109 Wis. 2d 256, 261, 325 N.W.2d 867, 869 (1982); Bouknight, supra note 131, at 22-23; Dubin & Navarro, supra note 128, at 141-42, 160-61; Houston, Albrecht & Redwood, supra note 130, at 463-66; Wells, supra note 130, at 16-17; cf. Note, supra note 11, at 109 (not allowing some recovery of prudently incurred costs will have chilling effect on utility planning decisions).


135. See Bouknight, supra note 131, at 22; Charnoff, Why Management Did It All Right: Overregulation and Other Acts of God, 33 U. Kan. L. Rev. 481, 481 (1985); Dubin & Navarro, supra note 128, at 141-42; Pierce, supra note 9, at 528-29 & n.182; Wells, supra note 130, at 16-18.


ostensibly "proconsumer" rate-suppression associated with an unfavorable regulatory climate has the potential to harm both consumers and the nation. . . . [E]lectricity rates may rise directly because of higher capital costs, while ratepayers may also bear an indirect petroleum penalty equal to the savings forgone by utilities which are unable (or unwilling) to undertake otherwise economic investments in new power plants and coal conversions which displace petroleum.

\textit{id.} at 160-61 (emphasis in original). Congress' concern with the country's dependence upon petroleum and natural gas as primary energy sources was expressed in the Powerplant and Industrial Fuel Use Act of 1978, 42 U.S.C. § 8301 (1982). One of the purposes of the Act was to encourage the development of alternatives to petroleum and natural gas. See 42 U.S.C. § 8301(b) (1982). Indeed, currently "some utility experts are concerned [about reliance on natural gas-fired plants] because . . . [o]f the prospect of a dangerous overreliance on a single fuel source." Wald, Growing Use of Electricity Raises Questions on Supply, N.Y. Times, Mar. 21, 1990, at D1, col. 1.
Confronted with the risk that their investments, though prudently incurred, will nonetheless be disregarded if they result in property that is not used and useful, utilities will be less likely to commit capital for new generating plants. This does a disservice to current ratepayers and is inequitable to future ratepayers.

Utilities generally have a statutory obligation to serve the public. This duty includes providing continuous service to all customers on equal terms at fair rates. Fulfilling this continuing obligation requires investment in plant additions. Indeed, the public utility "substitute[s] for the state in the performance of the public service; thus becoming a public servant." When a public utility fulfills this obligation by investing in additional capacity, and does so prudently, it should at least be allowed consideration of these expenditures in the Hope bal-

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139. See Mid-Tex Elec. Coop., Inc. v. F.E.R.C., 773 F.2d 327, 334 (D.C. Cir. 1985); Note, supra note 9, at 361 & n.109. But see Note, supra note 9, at 360 & n.98 (departures from used and useful standard are inequitable because current and future ratepayers are not necessarily the same group).

Intergenerational equity is one of the principles of the used and useful ratemaking methodology and is one of the reasons advanced for denying rate base treatment of property not yet used and useful. See Mid-Tex Elec. Coop., 773 F.2d at 334; Regulations Preambles, II F.E.R.C. ¶ 30,455, at 30,508 (1983) (Order No. 298), aff’d in part, vacated in part on other grounds, Mid-Tex Elec. Coop., Inc. v. F.E.R.C., 773 F.2d 327 (D.C. Cir. 1985). However, denying recognition of current expenditures for future generating capacity ignores the benefits that accrue to current ratepayers, such as an assurance of a continuing supply of energy. See 773 F.2d at 334; Regulations Preambles, II F.E.R.C. at 30,506-07; Hoecker, supra note 2, at 319-20. It also ignores the concerns of future ratepayers who have an interest in avoiding rate shocks. See 773 F.2d at 333-34; II F.E.R.C. at 30,499-500; see also Smartt, The Complexity of Things Regulatory, 115 Pub. Util. Fort., May 30, 1985, at 4 (rate shocks can be avoided by placing CWIP in rate base).

140. See supra note 8.

141. See C. Phillips, Jr., supra note 5, at 106.

142. See id.

143. See id.


ancing of interests.\textsuperscript{146}

Moreover, regulated utilities, unlike competitive enterprises, are not free to charge what the market will bear.\textsuperscript{147} In return for monopoly status, and presumably, limited down-side risk, utilities surrender the opportunity to earn tremendous profits.\textsuperscript{148} Thus, if a utility’s investment in new generating capacity yields extremely inexpensive energy, the utility “would . . . [receive] no windfall, but simply the standard return on its original investment.” \textsuperscript{149} It is inequitable, then, that the utility should bear all of the loss when its prudent investment fails.\textsuperscript{150}

\textbf{CONCLUSION}

The mandate of \textit{Hope} is clear: the end result of a rate order must be just and reasonable. In determining the reasonableness of utility rates, courts must weigh the affected investor and consumer interests.

Several courts have misapplied the investor interest component of the \textit{Hope} balancing standard. These courts have needlessly skewed the \textit{Hope} balance of interests by incorporating the used and useful ratemaking methodology into the constitutional inquiry. Rather, a court should consider all prudently incurred investment when formulating the investor interest of \textit{Hope}. This approach is more consistent with \textit{Hope} and its progeny and will provide a more equitable and efficient framework for both ratepayers and utility investors.

\textit{Sean P. Madden}


\textsuperscript{148} See Houston, Albrecht & Redwood, \textit{supra} note 130, at 462-63.

\textsuperscript{149} Jersey Cent. Power & Light Co. v. F.E.R.C., 810 F.2d 1168, 1181 n.2 (D.C. Cir. 1987) (en banc); see Bouknight, \textit{supra} note 131, at 22-23; Houston, Albrecht & Redwood, \textit{supra} note 130, at 462-63; Note, \textit{supra} note 9, at 374-75; Kahn, \textit{supra} note 147, at 26, cols. 3-4.